Supreme Court, U.S.
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No. 98-2010

IN THE
Supreme Court of the United States

THE CHARLES SCHWAB CORPORATION and INCLUDABLE SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY BRIEF FOR THE PETITIONERS

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TABLE OF AUTHORITIES

Page

Cases:

Anderson v. Commissioner,
527 F.2d 198 (9th Cir. 1975) 7

Central Cuba Sugar Co. v. Commissioner,
198 F.2d 214 (2d Cir. 1952) 5

Challenge Publications, Inc. v. Commissioner,
845 F.2d 1541 (9th Cir. 1988) 6

Continental Tie & Lumber Co. v. United States,
286 U.S. 290 (1932) 4, 5, 10

Dally v. Commissioner,
227 F.2d 724 (9th Cir. 1955) 5

Georgia School-Book Depository, Inc. v. Commissioner,
1 T.C. 463 (1943) 5, 7

Resale Mobile Homes, Inc. v. Commissioner,
965 F.2d 818 (10th Cir. 1992),
cert. denied, 506 U.S. 874 1992) 5, 6

Rowan Cos. v. United States,
452 U.S. 247 (1981) 8

United States v. General Dynamics Corp.,
481 U.S. 239 (1987) ..... *passim*

Yadav v. Charles Schwab & Co., Inc.,
[1990] Transfer Binder] Fed. Sec. L. Rep. (CCH)

¶ 95,376 (S.D.N.Y. July 18, 1990), *aff'd*, 948 F.2d 1277 (2d Cir. 1991) 3

Statutes:

Exchange Act, 15 U.S.C. § 78a *et seq.* 3

Exchange Act, Section 3(a)(13), 15 U.S.C. § 78c(a)(13) 6

Exchange Act, Section 3(a)(14), 15 U.S.C. § 78c(a)(14) 6

Exchange Act, Section 3(a)(23)(A), 15 U.S.C. § 78c(a)(23)(A).1 4

Exchange Act, Section 16(b), 15 U.S.C. § 78b(b) 6

Exchange Act Section 17A, 15 U.S.C. § 78q-1 4

Tax Reform Act of 1986, P.L. 99-514 7

Regulations and Rules:

Rule 15b-7, 17 C.F.R., § 240.15b7-1 4

Rule 10b-10, 17 C.F.R. § 240.10b-10 3

Rule 15c1-1(b), 17 C.F.R. § 240.15c1-1(b) 3

Rulings and Releases:

Rev. Rul. 74-372, 1974-2 C.B. 147 ..... 6, 7

Rev. Rul 78-270, 1978-2 C.B. 215 7

Rev. Rul. 93-84, 1993-2 C.B. 225 7

General Counsel Memorandum 34853 (April 21, 1972) 7

Field Service Advice 199904031(Nov. 16, 1998) 8

Technical Advice Memorandum 9409007
(Nov. 16, 1993) 8

S.E.C. Release No. 34-33023,
55 S.E.C. Docket 332 (Oct. 6, 1993) 4

S.E.C. Release No. 34-32018,
58 Fed. Reg. 16151 (1993) 4

Legislative History:

S. Rep. No. 99-313, 99th Cong., 2d Sess. 124; 1986-3
(Vol. 3) C.B. 131 7

REPLY BRIEF FOR THE PETITIONERS

1. Respondent begins the substance of his argument by asserting that it is the "execution" of a trade order -- *i.e.*, the matching of a buyer with a seller or vice versa -- that fixes Petitioner's right to its commission. This is so, Respondent asserts, because "the sole service for which customers agree to pay a commission to petitioner is the execution of securities trades" (Resp. Br. 8). This assertion is flatly contradicted by the record. The standard customer contract between Petitioner and its customers states without qualification that the customer agrees to pay a commission only when a purchase or sale transaction is effected in the customer's brokerage account (Pet. Br 4).[1] Moreover, the confirmation/invoice Petitioner sends to its customer after a trade is executed but before settlement, states that payment is due on the *settlement* date. (Pet. Br. 4.) Thus, unless Petitioner settles the transaction -- which means effecting the actual exchange of money and securities, not merely the execution of a trade order -- it has no contractual right to be paid.[2]

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[1] We reproduce the contract's "Terms and Conditions" section in the Appendix because of Respondent's misconceptions about this critical point. *See* Reply App. 1-a, Part 1, par. 1, which states: "Schwab will open a Cash Account for you and will act as your broker in purchasing and selling securities on your instructions. ... You agree to pay Schwab's brokerage fees, as they exist from time to time, for securities *transactions* in your Brokerage Accounts" (emphasis supplied). Executing a trade order is merely the first step of a "transaction" in the customer's account that is completed when settlement occurs.

[2] Respondent evidences a continuing, fundamental lack of comprehension of the essence of Petitioner's contract with its customers (Resp. Br. 11 n.2). Customers hire Petitioner to secure for them the fruits of a completed transaction -- net cash proceeds if the transaction is a sale; securities if the transaction is a purchase. The accuracy of this description is clear from the terms of the contract and from plain common sense. If Petitioner ceased its activities after merely "executing" a trade order, Petitioner's customer would have no ability to settle the transaction on her own since (among other things) the buyer or seller is unknown to Petitioner's customer due to the very mechanics of the securities exchange system. Without Petitioner's post-execution activities, Petitioner would not have earned its commission but would have a very annoyed, empty-handed customer to deal with.

(footnote continued...)

2. Respondent contends that execution "fixes" Petitioner's right to the commission because once a customer's buy order or sell order has been executed, the customer loses the ability to cancel the order (Resp. Br. 5-6, 9). Respondent thus advances here the argument that the *taxpayer* made (and this Court rejected) in *United States v. General Dynamics*, 481 U.S. 239 (1987). In *General Dynamics*, the taxpayer maintained a medical expense reimbursement plan for its employees. The taxpayer argued that once an employee had incurred covered medical expenses, the taxpayer lost any ability to avoid liability for reimbursement by taking any unilateral action, and that there was only a remote possibility that the employee would fail to file a claim. The taxpayer argued that, as a result, it was entitled to accrue a deduction for its inevitable liability for those claims. This Court nonetheless held that the taxpayer's potential reimbursement obligation could not be accrued under the "all events" test. This Court agreed with Respondent's view, in that case, that an unconditional obligation to make a payment to an employee did not arise until that employee filed a claim for reimbursement. This Court noted that even though the taxpayer "could not avoid its obligation to pay for services after they were received by, for example, discharging the employee...[t]he filing of the claim is ... a true condition precedent to liability on the part of the taxpayer." 481 U.S. at 244 n.5.

Similar facts are present in this case. Upon execution of the customer's order, there is a contra-broker whose customer has

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Respondent contends that the foregoing "misdescribes the nature of the transaction" because Petitioner "executes securities sales and purchases solely as a broker or agent ... and not as a principal." *Id.* Respondent's statement is a baffling *non sequitur*. When Petitioner delivers the cash or securities into the customer's brokerage account at settlement, it is indeed acting as an agent and not as a principal for its customer; the nature of the transaction is nonetheless as described above. Petitioner acts as a principal only when it is trading for its own brokerage account and not for its customer accounts; even in that case, the essence of the transaction is the delivery of the cash or securities at settlement into Petitioner's brokerage account.

accepted the terms of the offer and agreed to be on the other side of the trade. Therefore, Petitioner's customer has lost the ability to avoid paying the commission by unilaterally reneging on the trade.[3] Like the employer-taxpayer in *General Dynamics*, who was obligated to pay the employee unless the employee failed to meet his contractual obligation to file the claim, Petitioner's customer must pay the brokerage commission unless Petitioner fails to meet its contractual obligation to effect the transaction. As in *General Dynamics*, the fact that only Petitioner's failure, for whatever reason, to complete the transaction can avoid that payment obligation serves to underscore the status of Petitioner's obligation as a true condition precedent. Unless and until the transaction is completed -- on the settlement date -- there is no unconditional right to the commission income.

3. Respondent contends that Petitioner's services in "delivering the securities and collecting its commission"[4] following execution of a trade order are "administrative" and

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[3] Respondent cites *Yadav v. Charles Schwab & Co., Inc.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,376 (S.D.N.Y. July 18, 1990), *aff'd*, 948 F.2d 1277 (2d Cir. 1991) (Resp. Br. 5-6). That case is inapposite for many reasons. First, Petitioner was found entitled to its commission because it completed the stock purchase transaction, not merely because it executed the order. Further, in *Yadav*, both parties *agreed* that the customer's request to cancel was not effective if made after the order was executed. The issue was, therefore, merely one of credibility. The customer claimed that he had told Petitioner to cancel the order on October 19, 1987 (Black Monday), *before* the order had been executed. The New York Stock Exchange arbitration panel, however, believed Petitioner's statement that Yadav attempted to cancel the order only *after* it had been executed, in the hope of avoiding losses in a plummeting market.

[4] Contrary to Respondent's assertion, Petitioner does not contend that "collecting" the commission (Resp. Br. 9) is a precondition to its right to the commission. However, *sending* the customer a confirmation is required by the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a *et seq.* (The "Exchange Act"), and is such a precondition. Petitioner sends a confirmation the day after the trade date showing the amount of commission due (and other information) in order to comply with the anti-fraud provisions applicable to brokers and dealers. Rule 10b-10, 17 C.F.R. § 240.10b-10 (formerly Rule 15c1-4), requires the confirmation by the "completion of the transaction" -- which the SEC has ruled is settlement. Rule 15c1-1(b), 17 C.F.R. § 240.15c1-1(b).

"ministerial in nature" (Resp. Br. 4, 9). However, the courts below made no factual findings that justify that legal characterization of Petitioner's activities, and Respondent's legal arguments do not compel it. Any potential right to commission income that arises from the execution of the order is uncertain and contingent until the occurrence of two future events -- clearing[5] and settling[6] the transaction, which are both required by the U.S. Securities and Exchange Commission.[7] Those are not merely "administrative" or "ministerial" matters. They are substantive requirements of Petitioner's contract with its customers and of the federal securities laws. It is only after the completion of these additional steps that a customer has any liability to Petitioner, and until that time, Petitioner's right to its commissioner is not "firmly established" within the meaning of *General Dynamics*, 481 U.S. at 243.

4. The apparent crux of Respondent's argument is his discussion of case law regarding "ministerial" acts, since in this discussion, Respondent in effect urges an expansion of the scope

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[5] The term "clearance" includes the comparison of data regarding the terms of settlement of securities transactions and the allocation of securities settlement responsibilities. After trade comparison, Petitioner's, as well as most other brokers', trades clear through a continuous net settlement system ("CNS") operated by a clearing corporation registered with the Commission under Exchange Act § 17A, 15 U.S.C. § 78q-1. Under CNS, the clearing corporation nets each clearing member's purchases and sales to arrive at a daily net receive or deliver obligation for each security and a daily net settlement payment obligation. S.E.C. Release No. 34-33023, 55 S.E.C. Docket 332 (Oct. 6, 1993), at n.5; *see* Exchange Act, § 3(a)(23)(A), 15 U.S.C. § 78c(a)(23)(A).1.

[6] The term "settlement" includes the delivery of securities in exchange for funds, pursuant to the terms of the originating order, and the custody of securities. *Id.*

[7] Moreover, Congress and the S.E.C. have declared that clearance and settlement are integral aspects of effecting a securities transaction and are not "clerical" or "ministerial" functions, and that a broker is providing brokerage services when it clears and settles a transaction. Exchange Act § 17A, 15 U.S.C. § 78q-1; S.E.C. Release No. 34-32018, 58 Fed. Reg. 16151, 16153 & n.25 (1993) (promulgating Rule 15b-7, 17 C.F.R. § 240.15b7-1); *see generally* S.E.C. Release No. 34-33023, 55 S.E.C. Docket 332 (Oct. 6, 1993).

of the term "ministerial acts" as laid down by this Court in *Continental Tie & Lumber Co. v. United States*, 286 U.S. 290, 295-96 (1932), and as adhered to in *General Dynamics*. In fact, none of the cases cited by Respondent or in the opinion below supports the proposition that a party's performance of its contractual duties can be dissected into "essential" acts and lesser acts that are "ministerial" "conditions subsequent." Instead, the cited cases hold that the term "ministerial acts" only encompasses the computation or collection of sums already earned following completion of a party's contractual performance. *Continental Tie & Lumber Co. v. United States*, 286 U.S. 290 (1932) (performance completed; mathematical computations were ministerial); *Dally v. Commissioner*, 227 F.2d 724 (9th Cir. 1955) (performance completed; billing and collection were ministerial); *Resale Mobile Homes, Inc. v. Commissioner*, 965 F.2d 818, 823 (10th Cir. 1992), *cert. den.* 506 U.S. 874 (1992) (performance completed; computations were ministerial, contingencies as to collectibility were conditions subsequent); *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214, 217-18 (2d Cir. 1952) (performance of services completed; computations were ministerial, contingencies as to collectibility were conditions subsequent); *Georgia School-Book Depository, Inc. v. Commissioner*, 1 T.C. 463, 468-470 (1943) (performance completed; contingencies as to collectibility were conditions subsequent).

Respondent further contends that the filing of the claim forms by employees was not ministerial because of the possibility that claim forms would not be filed, and that "by contrast," the *processing* of the claim forms was merely "ministerial" (Resp. Br. 10). Petitioner respectfully submits that the reason that the filing of claim forms was not a "mere technicality" (*General Dynamics*, 481 U.S. at 244) was instead that, under the terms of the contract between General Dynamics and its employees, General Dynamics was "liable to pay for covered medical services *only* if properly documented claims forms were filed." *Id.*; emphasis in original. This Court thus concluded that, "as a matter of law, the filing of a claim was necessary to create

liability." In the instant case, the last act necessary to secure to Petitioner the contractual right to payment was settlement of the transaction. As was true of the claim filings in *General Dynamics*, settlement of transactions in the instant case was, while not a certainty, statistically highly probable.

Therefore, contrary to Respondent's assertion, *General Dynamics* rules the outcome of this case, and the decision below is inconsistent.

5. Whether the inclusion of an item in income is required because the "all events" test has been satisfied is a question of law, *Challenge Publications, Inc. v. Commissioner*, 845 F.2d 1541, 1543 (9th Cir. 1988); *Resale Mobile Homes, Inc. v. Commissioner*, 965 F.2d at 821. The concern this Court may have over disturbing a lower court's findings of fact is not present in this case. Indeed, in *General Dynamics* itself, both lower courts found that filing the claim forms in question was not necessary to accrual -- findings reviewed and reversed by this Court. Therefore, this Court should not hesitate to reject, as Petitioner urges it to do, the lower courts' mistaken characterization of substantive contractual duties as "ministerial acts."

6. Respondent asserts that when he issued Rev. Rul. 74-372, 1974-2 C.B. 147, he took the "position" that brokers must accrue commissions on trade dates "consistent with th[e] general principle" that "petitioner's customers must themselves recognize gain or loss from any sale of securities on the trade date" (Resp. Br. 11).[8] Respondent is engaging in wishful revisionist history.

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[8] Respondent asserts the irrelevant in stating that "in insider trading cases, courts have held that the trade date, rather than settlement date, determines" short-swing profits liability under Section 16(b) of the Exchange Act, 15 U.S.C. § 78b(b). Courts have held in that manner because the provisions of the Exchange Act require them to treat the trade date as determinative. Exchange Act §§ 3(a)(13) and (14), 15 U.S.C. §§ 78c(a)(13) and (a)(14), define, respectively, the terms "buy" and "purchase" as each including any *contract* to buy, purchase, or otherwise acquire securities, and the terms "sale" and "sell" as each including any *contract* to sell or otherwise dispose of securities. It is the trader's *agreement* to do the transaction, which occurs on the trade date, that fixes Section 16(b) liability. The contract date, rather

(footnote continued...)

In 1974, and up until 1986, as Respondent's own published revenue rulings recognize, *see, e...* Rev. Rul. 78-270, 1978-2 C.B. 215, the "general principle" was that customers recognized gains *on the settlement date*, when they received the proceeds of sale.[9]

Rev. Rul. 74-372 was instead a reflection of a litigation goal formulated in Respondent's General Counsel Memorandum ("G.C.M.") 34853 (April 21, 1972).[10] In G.C.M. 34853, Respondent reviewed the Tax Court's decision in *Georgia School-Book Depository v. Commissioner*, *supra*, a case in which a school-book broker was required to accrue commission income upon delivery of books to the state instead of upon receipt of payment from the state. *Georgia School-Book Depository* simply states the rule that billing and collection are not part of the activities that earn the right to income. However, in G.C.M. 34853, Respondent expressed the "belief" that *Georgia School-Book Depository* stands for a much broader principle, namely that income can accrue upon performance of

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than the settlement date, is determinative because the issue is whether the trader was a statutory insider presumed to have access to inside information on the day he became obligated to buy or sell the stock. If the settlement date were used, insiders could buy or sell on the trade date, take some action before the settlement date to change their insider status (*e.g.*, more-than-10% shareholders could dump enough stock to lose their statutory insider status), and avoid Section 16(b) liability.

[9] Respondent's contention that the income tax consequences to customers have any relevance to this case is unfounded (Resp. Br. 11). *Anderson v. Commissioner*, 527 F.2d 198 (9th Cir. 1975), has nothing to do with the *timing* of gain recognition from securities sales, but is concerned only with determining whether gains were long- or short-term. When Respondent issued Rev. Rul. 93-84, 1993-2 C.B. 225, it was merely a reflection of a statutory change to the installment sale rules made in the Tax Reform Act of 1986, P.L. 99-514. As a policy matter, installment method reporting of gain from the sale of publicly traded securities had been ended because it was thought that such securities were sufficiently liquid to make availability of the installment method unnecessary. *See* S. Rep. No. 99-313, 99th Cong., 2d Sess. 124; 1986-3 (Vol. 3) C.B. 131.

[10] G.C.M.s are issued by respondent's Chief Counsel, and reflect the highest level of Respondent's litigation policy.

"primary" services even though "other incidental services" have not yet been performed. In furtherance of this "belief," the G.C.M. directs the issuance of Rev. Rul. 74-372. Rev. Rul. 74-372, therefore, does not reflect any substantive study of broker-dealers but is merely a litigation wish using broker-dealers as a convenient vehicle. In addition, it is clearly inconsistent with the holding of this Court in *General Dynamics*. Consequently, it is entitled to no deference by this Court.

7. Respondent asserts that "[i]n this context," it is "plainly unwarranted" to think that the lower courts' decision in this case will "destabilize and 'confuse the Nation's taxpayers'" in determining when items accrue for federal income tax purposes. The "context" to which Respondent refers, however, is only that of brokers accruing commissions. The danger -- and a substantial reason that Petitioner believes that this case merits this Court's review -- is that Respondent will seek to apply that decision in other "contexts."[11]

In our Petition, we expressed the concern that whether an act or event is considered "ministerial" is an essentially subjective standard that inherently cannot be consistently applied and, if the decision below is allowed to stand, will produce different results for similar taxpayers in similar circumstances. It is telling that Respondent did not respond in his Opposition Brief to those concerns, particularly since they are dramatically illustrated by Respondent's own inconsistency in determining whether given acts are or are not "ministerial" -- a determination that is at the very core of the test that Respondent is seeking to uphold.

In Technical Advice Memorandum ("TAM") 9409007 (Nov. 16, 1993), Respondent himself, in technical advice to his field

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[11] In Field Service Advice 199904031 (Nov. 16, 1998), even before the Ninth Circuit had spoken in the instant case, Respondent applied the Tax Court decision below to signing bonuses of a taxpayer in an operating business:

> Although [the taxpayer's] failure to fulfill its obligations might ultimately divest [it] of its right to the bonus, the conditions imposed in the contract are insufficient in our view to prevent [the taxpayer] from acquiring a right to the bonus in Year 1 and do not preclude accrual of the income. *See Schwab*, 107 T.C. at 293-294.

agents,[12] characterized the filing of the employee claims in *General Dynamics* as "ministerial." but, nonetheless, a legal condition precedent to accrual:

> The Court [in *General Dynamics*] stated that deduction of the reserve accounts failed the all events test because the last event necessary to fix the taxpayer's liability was not the receipt of medical care by covered employees, but rather, the filing of properly documented claims forms. Such a filing, *although ministerial in nature*, was not a mere technicality but rather a condition precedent of liability. [Emphasis added.]

Thus, in advising his field agents, Respondent characterizes the filing of claim forms in *General Dynamics* as "ministerial." In contrast, in its Opposition Brief, Respondent asserts to this Court that the same filings of the same forms to obtain reimbursement from the same employer (General Dynamics) were *not* "ministerial." Petitioner submits that the need for this Court's review of this case is amply demonstrated by Respondent's changeable attitude on the issue of what "ministerial" signifies even in a single context. It is a virtual certainty that, if the decision below is allowed to stand, minor variations in facts will lead to inconsistent differences in characterization and unpredictability in application of the federal income tax laws which the courts will be time and again asked to resolve.

8. In Respondent's petition for certiorari in *General Dynamics*, Respondent stated (at pages 7-8):

> This case presents an important question of federal tax law. The decision below is squarely at odds with fundamental principles that this Court has enunciated to govern accrual of [items] under the "all events" test of tax accounting, and

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[12] Because TAMs arise in the context of actual audit controversies, they are widely relied upon by Respondent's agents -- and by taxpayers -- as authoritative expressions of Respondent's administrative positions. *Cf. Rowan Cos. V. United States*, 452 U.S. 247, 261 n.17 (1981).

it conflicts with the decisions of other courts of appeals that have applied those principles.

Respondent argued that "[t]he decision below produces an irrational result" and that the "impact" of the lower court decision, having been "rendered by a court of nationwide jurisdiction, is substantial." Respondent concluded that "[r]eview by this Court is therefore appropriate."

The instant case is essentially *General Dynamics* applied to income items instead of deduction items, and we respectfully submit that it is as significant to the Nation's taxpayers. Because it affects basic elements of the "all events" test, the lower courts' decision affects every accrual-method taxpayer in the nation, as did *General Dynamics*. The decision below is, as we believe we have demonstrated, squarely at odd with the principles that this Court enunciated in *General Dynamics* and *Continental Tie & Lumber Co.* and therefore conflicts with every other decision that applies those principles. The Ninth Circuit adopted the decision of the Tax Court -- a court of nationwide jurisdiction -- and the resulting impact if that decision is allowed to stand cannot be other than substantial. In consequence, we believe that review of that decision by this Court is necessary.

CONCLUSION

For the foregoing reasons and those stated in the Petition, this Court should grant the Petition for a Writ of Certiorari.

Respectfully submitted,

Dated: August 1999

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APPENDIX A

SCHWAB BROKERAGE ACCOUNT TERMS AND CONDITIONS

The Cash Account is the basic brokerage account offered by Schwab. In addition to the Cash Account, you may elect to maintain with Schwab a Margin and Short Account and/or an Options Account. These accounts, along with the Cash Account, are referred to in these Terms and Conditions as the "*Brokerage Accounts.*"

PART I: BROKERAGE ACCOUNTS

1. *Purchase of Sale of Securities*. Schwab will open a Cash account for you and will act as your broker in purchasing and selling securities on your instructions. If you apply and Schwab approves your application, Schwab will also open a Margin and Short Account and/or an Option Account. You agree to pay Schwab's brokerage fees, as they exist from time to time, for securities transactions in your Brokerage Accounts.

2. *Services Provided*. Schwab executes orders for securities only and does not give investment advice. Schwab will not advice you on any matter pertaining to the suitability of any order for you or offer any opinion concerning the nature, potential value, or suitability of any particular security.

3. *Applicable Rules and Regulations*. All transactions shall be subject to the rules, regulations, customs and usages of the exchange, market, or clearing house where executed, and to all applicable federal and state laws, rules, and regulations.

4. *Deposit of Equity*. Schwab may require full payment or an acceptable equity deposit prior to the acceptance of any order.

5. *Security for Indebtedness*. As security for the discharge of all your indebtedness and other obligations to Schwab under these Terms and Conditions, you grant to Schwab a security interest in all securities or other property now or hereafter held, carried, or maintained for any purpose in or for any of your present or future Brokerage Accounts, whether individual or jointly held with others. Whenever Schwab, in the reasonable exercise of its sole discretion, deems it necessary for its

protection, or to satisfy a margin deficiency, Schwab may sell, assign, and deliver all or any part of the securities or other property, or close any or all transactions in your Brokerage Accounts. Schwab shall also have the right to transfer securities and other property in any of your Brokerage Accounts from or to any other of your Brokerage Accounts, if in Schwab's opinion there is inadequate security for your obligations or if necessary to satisfy a margin deficiency.

6. *Payment of Indebtedness Upon Demand.* You will at all times be liable to make payment upon demand of any debit balance or other obligation owing in any of your Brokerage Accounts.

7. *Customer Remittances.* You may make remittances for credit to your Brokerage Accounts at any Schwab office. If a check or other item you remit to Schwab is returned unpaid, Schwab will deduct a $15 fee from your Brokerage Accounts.

8. *Customer Duties on Sale of Control or Restricted Securities.* Prior to giving Schwab a sell order in connection with any securities subject to Rules 144 or 145(d) under the Securities Act of 1933, you agree to advice Schwab of the status of such securities and to furnish or cause to be furnished promptly such information and documents (including opinions of your counsel) that Schwab may require in order to comply with its regulatory duties.

9. *Change in Account Information.* You agree to notify Schwab in writing if there is any material change in the facts set forth in the Account Information section of your New Account Application and Agreement. In particular, you agree to inform Schwab in writing if you become a director, 10% shareholder, or policy-making officer of a publicly-traded company, or if you become affiliated with or employed by any securities firm, bank, trust, or insurance company.

10. *Multiple Account Holders.* If there is more than one account holder, each account holder shall have authority, acting alone, to take action with respect to such account, and Schwab may deliver securities and other property in connection with account transaction to any account holder without notice to the other.

11. *Definitions*. For purpose of this Agreement, "securities" and "other property" shall include money and securities of any kind and nature and all contracts and options relating there. To "*close any or all transactions*" with respect to any account shall mean to cancel any or all open orders, to sell any or all outstanding long contracts or securities, and to buy any or all securities and other property that may be short in such account. Such transactions may be made without notice or demand, and may be made on whatever exchange or market and in whatever manner (including public auction or private sale) Schwab deems most expeditious, in the exercise of its business judgment.